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Before the
Federal Communications Commission
Washington, D.C. 20554

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In the Matter of:	)	
Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as Amended	)	
and	)	CC Docket No. 96-149
Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area	)	

COMMENTS OF THE SOUTHERN NEW ENGLAND TELEPHONE COMPANY

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Table of Contents

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To: The Commission

COMMENTS OF THE SOUTHERN NEW ENGLAND TELEPHONE COMPANY

The Southern New England Telephone Company ("SNET") responds below to the Commission's request for comments on whether to revise the way it regulates interstate service provided by an independent LEC to customers within that LEC's exchange area ("in-region interstate service").[1/] Under one option, the agency would eliminate a 13-year-old policy which authorizes independent LECs to offer in-region interstate service under non-dominant regulation only when the service is provided through an entity other than the one providing access service. Eliminating that policy would permit independent LECs to provide in-region interstate service under non-dominant regulation when they provide both interstate service and

[1/] An "independent" LEC is a LEC having no ownership affiliation with a BOC.

access service through the same entity. SNET's comments explain why the Commission should eliminate the subject policy.[2/]

As the Commission considers whether to permit independent LECs to provide in-region interstate service under non-dominant regulation through the same entity that provides access service, it should keep in mind that granting this authority would not result in the elimination of any existing Commission policy other than the one that bars this method of operation. For example, a Class A independent LEC still would be required to separate its costs to provide interstate service from the costs to provide access service in accordance with the FCC's Part 64 cost allocation rules. Similarly, the LEC still would be required to keep books of account for its interstate service operations in compliance with generally accepted accounting procedures.[3/]

[2/] In the Notice that initiated this proceeding, the Commission stated that comments on all issues, including the one on which SNET comments, would be due August 15, 1996. Later, the agency issued an order extending to August 29 the filing deadline for comments concerning the issue of defining an appropriate regulatory structure for provision of in-region interstate service by independent LECs. Order, DA 96-1281 (rel. Aug. 9, 1996). SNET's Comments, filed on August 29, are timely since they deal entirely with the issue of defining an appropriate regulatory structure to govern provision of in-region interstate service by independent LECs.

[3/] Pacific Telesis, in comments filed early, asks the Commission to require an independent LEC to provide out-of-region interstate service through an entity other than the entity providing access service in order for that out-of-region service offering to qualify for non-dominant regulation. See Pacific Telesis Comments at 69-70 (CC Dkt. No. 96-149, filed Aug. 15, 1996). However, the issue of how the FCC should regulate a LEC's out-of-region interstate service is beyond the scope of the present (continued...)

INTRODUCTION AND SUMMARY OF ARGUMENT

1. Introduction

Many independent LECs offer in-region interstate service. They do so in a David and Goliath struggle against companies which are among the largest corporations in the world. Indeed, 98 percent of the nation's roughly 1,100 independent LECs have annual revenues of less than $50 million per year,[4] an amount which pales when compared to the revenues of the four companies (AT&T, MCI, Sprint, and WorldCom) which together have substantially more than 90 percent of the country's interstate service market. Indeed, a LEC whose revenues are in the 98th percentile of all independent LECs has revenues which are just six one hundredths of one percent (.06%) of AT&T's revenues,[5] less than four tenths of one percent (.4%) of MCI's and Sprint's revenues,[6] and only 1.4 percent of

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[3] (...continued) proceeding. That issue is before the Commission in a different proceeding. (CC Dkt. No. 96-61). The issue before the Commission in the present proceeding is how to regulate a LEC's in-region interstate services. Pacific Telesis expresses no opinion in its comments on how the FCC should regulate in-region interstate services offered by an independent LEC's access affiliate.

[4] Just 20 of the 1,100 independent LECs had more than $50 million in operating revenues in 1994, just seven had operating revenues in excess of $500 million, just four (GTE, Sprint, SNET, and ALLTEL) had operating revenues in excess of $1 billion, and just two (GTE and Sprint) had more than $2 billion in operating revenues. See U.S. Tel. Ass'n, Phone Facts 1995 at 10-11.

[5] See AT&T Annual Report to Shareholders at 2 (reporting that AT&T's 1995 revenues were $79.6 billion.

[6] See Electronic Media (Feb. 5, 1996) (reporting that MCI's 1995 revenues were nearly $15.3 billion; Sprint Annual Report to (continued...)

WorldCom's revenues.[7] Even SNET, the third largest of the two percent of independent LECs with revenues in excess of $50 million per year, has resources that are no match for these interstate service giants. Indeed, SNET's 1995 revenues were just three percent of AT&T's revenues, 12 percent of MCI's revenues, 14 percent of Sprint's revenues, and only half of WorldCom's revenues.

Not only do independent LECs compete with interstate service providers many times their size, they also compete in an environment of rapidly growing competition in their own core markets as SNET's own experience illustrates. Fifteen companies -- including AT&T, MCI, and the two largest cable operators in SNET's service area -- have obtained regulatory authority to provide telephone exchange service in direct competition with SNET. Moreover, the two cable operators, TCI and Cablevision, already have spent hundreds of millions of dollars upgrading their cable TV networks within SNET's service area in order to provide telephone exchange service. In fact, TCI has used its upgraded network to test market an exchange offering, and it has announced that it will begin providing exchange service commercially in Hartford, the largest city in SNET's service area, by year's end.[8]

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[6](...continued) Shareholders (reporting that Sprint's 1995 revenues were nearly $12.8 billion).

[7] See WorldCom Form 10-K for year ending Dec. 31, 1995 (reporting that WorldCom's 1995 revenues were $3.64 billion).

[8] See, e.g., "TCI Cleared to Provide Telephony in Connecticut", Telecom. Reports at 10-11 (Aug. 26, 1996).

SNET faces head-to-head competition from the interstate service giants in the intraLATA toll market as well, and state regulatory policy ensures that SNET and its competitors compete in this market on equal terms. It does this (a) by requiring that all intraLATA toll customers be given the ability to make intraLATA toll calls through 1+ dialing regardless of their intraLATA toll provider and (b) by giving all intraLATA toll customers the right to select one service provider for interstate toll calls and a different service provider for intraLATA toll calls.[9/]

Competition in the access service market within SNET's service area is intense too. MFS and TCG, the country's largest competitive access providers, have deployed fiber optic networks in the large towns in SNET's service area, and they use these networks to offer access service to the giant interstate service providers as well as to end user customers.

Unfortunately, the FCC's 13-year-old dominant carrier/non-dominant carrier policy complicates the ability of independent LECs to provide in-region interstate service notwithstanding their small size and the growing competition in their own core markets.[10/] If independent LECs want the operational efficiency of providing inter-

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[9/] All in-state toll calls in SNET's service area are intraLATA calls since SNET's service area is entirely within Connecticut, a single LATA state.

[10/] The dominant/non-dominant policy applicable to independent LECs was adopted in Policy and Rules Governing Rates for Competitive Common Carrier Services, Fourth Report and Order, 95 F.C.C. 2d 554, 576-79 (1983), clarified, Fifth Report and Order, 98 F.C.C. 2d 1191, 1198-99 (1984).

state service through the same company that provides access service, the dominant/non-dominant policy requires that they endure the inefficiency of dominant carrier regulation. If they want the operational efficiency of providing interstate service under the same non-dominant regulation rules with which their giant competitors comply, they must endure the inefficiency of providing interstate service through a different entity than the one through which access service is provided.

Either choice puts an independent LEC at a competitive disadvantage in providing interstate service. Dominant regulation gives the giant interstate service competitors an opportunity to thwart the LEC's marketing initiatives by requiring the LEC to give those competitors a minimum of 14 days advance notice -- and often 45 days or even 120 days of advance notice -- before changing an interstate service price or initiating any new service.[11/] Dominant regulation also imposes significant regulatory costs on independent LECs by requiring them to present the FCC with economic data demonstrating that interstate service price changes are reasonable.[12/]

<u>Non-dominant</u> regulation likewise requires independent LECs to operate inefficiently given the requirement to provide interstate

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[11/] 47 C.F.R. §§61.41, 61.58(c), 61.58(e).

[12/] <u>Id</u>. <u>See also</u> 47 C.F.R. §61.38. By contrast, non-dominant regulation permits a service provider to change price and initiate a new interstate service by giving one-day notice, and it exempts the service provider from the obligation to submit economic data proving that price changes are reasonable.

service through a different entity than the one providing access service. The Commission recognized 13 years ago when it set up the non-dominant regulatory option for independent LECs that providing interstate and access services through different entities requires inefficient operation.[13/]

Most independent LECs entering the interstate service market in the last 13 years have chosen to provide service under non-dominant regulation. But the separate subsidiary requirement that accompanies eligibility for non-dominant regulatory treatment makes that option only slightly more attractive than dominant regulation for many of them.

2. Summary of Argument

The Commission should permit independent LECs to compete in the in-region interstate service market on regulatory terms that are more like the terms under which the giants who dominate that market are regulated. It may do this by allowing independent LECs to provide in-region interstate service under non-dominant regulation through the same entity that offers access service.

Permitting independent LECs to provide in-region interstate service in this manner is now required under the cost/benefit test the Commission used in 1983 to decide whether to permit this mode of operation even though the agency came to the opposite conclusion in applying the test then. This is because barring independent LECs from providing in-region interstate service under non-dominant

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[13/] Fifth Report and Order, supra, 98 F.C.C. 2d at 1199.

regulation through the entity that provides access service imposes the same costs but a far less substantial benefit than 13 years ago due to the changed marketplace and regulatory circumstances described in Section I below.

Permitting an independent LEC to provide in-region interstate service under non-dominant regulation through its access service affiliate also is consistent with the alternative test the Commission now states may guide its decision. Under that test, non-dominant regulation of in-region interstate service offered by the LEC's access service affiliate would be appropriate if that affiliate has no ability to monopolize provision of in-region interstate service. As demonstrated in Section I below, an independent LEC providing in-region interstate service through its access affiliate under non-dominant regulation would have no ability to monopolize provision of interstate service in the in-region interstate service market.

The principle of reasoned decision making also requires that the Commission permit independent LECs to provide in-region interstate service under non-dominant regulation through their access affiliates. This is because prohibiting this mode of operation is inconsistent with the FCC's own precedent and findings of fact, and it fails to help the agency prevent the cross-subsidization and discrimination that it is supposed to help prevent as explained in Section II below.

DISCUSSION

I. Sound Policy Requires the Commission to Let Independent LECs Provide In-Region Interstate Service Under Non-Dominant Regulation Through the Same Entity that Provides Access Service Since Changed Circumstances Have Substantially Eroded the Benefit of Prohibiting This Method of Operation

The FCC's 1983 order allowing independent LECs to provide interstate service under non-dominant regulation only through a different legal entity than the one providing access service was based on the agency's balancing of costs and benefits in light of circumstances which existed then. The Commission recognized that providing different services through different entities could impose costs by preventing the LEC from providing interstate service at optimal economic efficiency, but it felt the benefit outweighed this cost in the competitive and regulatory environment which existed in the early-1980's. The agency reasoned that it would be beneficial to require independent LECs to provide interstate service and access service through different legal entities as a condition to non-dominant regulation of their interstate services because it would help prevent these LECs from damaging competition in the interstate service market. The Commission thought that independent LECs would have an incentive to damage competition in that market given their market power in providing access service, a necessary input of interstate service. Moreover, because of the regulatory and market conditions that existed then, the agency felt there was a sizable risk that independent LECs might be able to capitalize on this incentive by actually damaging competition in the interstate service market if they provided interstate service under non-dominant regulation through the same entity which provides access service.[14/] The Commission believed that an independent LEC might hurt the interstate market in one of two ways. First, it might raise the cost to provide interstate service of its interstate service competitors by misallocating its own interstate service costs to the access service it provides those companies. Second, it might unfairly discriminate against its interstate service competitors by giving them access service that is qualitatively inferior to the access service it gives itself.[15/]

It is not clear from the Notice whether the Commission intends now to reapply the balancing test in determining whether to let independent LECs provide in-region interstate service under non-dominant regulation through their access affiliates. While using the balancing test is one option, the agency implies it may instead regulate the in-region offering of an independent LEC's access affiliate under dominant regulation only if it concludes that the access affiliate would have the ability to monopolize the in-region interstate market in the absence of dominant regulation.[16/] Under this monopoly power test, the in-region interstate service of an

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[14/] Fifth Report and Order, supra, 98 F.C.C. 2d at 1199.

[15/] Id., 98 F.C.C. 2d at 1204 (leveraging market power in access service market by allocating costs); Fourth Report and Order, supra, 95 F.C.C. 2d at 576 (leveraging market power by providing access service on discriminatory terms).

[16/] Notice at ¶¶156-57.

independent LEC's access affiliate would be regulated under dominant regulation only if the LEC's access affiliate is "able to disadvantage . . . [the LEC's] interexchange competitors to such an extent that . . . [the access affiliate] will quickly gain the ability profitably to raise the price of in-region, interstate . . . services significantly above competitive levels by restricting output . . . [or] rais[ing] its rivals' costs."[17/]

The Commission should now permit an independent LEC's access service affiliate to provide in-region interstate service under non-dominant regulation due to changes in the marketplace and regulatory conditions that have occurred in the past 13 years. As we show below, these changed circumstances justify permitting an independent LEC's access affiliate to provide interstate service under non-dominant regulation regardless of whether the FCC bases its decision on the balancing test or on the monopoly power test.

[17/] Id. For purposes of the present Comments, SNET does not challenge the FCC's assumption that an independent LEC with a demonstrable ability to monopolize the in-region interstate service market should be deemed to have monopoly power in the interstate service market. Instead, SNET demonstrates that an independent LEC providing in-region interstate service does not have an ability to monopolize the in-region interstate service market. In fact, however, Dr. William Taylor explains in an affidavit which already is part of the record of this proceeding that a LEC with an ability to monopolize the in-region interstate service market cannot lawfully be deemed to have monopoly power in the interstate service market unless the LEC also has the ability to monopolize the interstate service market in the nation as a whole. See Aff'd of Wm. E. Taylor at 8-11, attached as Exh. 2 to Comments of Bell Atlantic (CC Dkt. No. 96-149, Aug. 15, 1996). It is plain beyond dispute that no independent LEC could possibly have monopoly power in the interstate service market in the nation as a whole even if it had such power (which it does not as shown below) within its own geographically limited in-region service area.

A. The Incentive of Independent LECs to Seek to Damage Competition In the In-Region Interstate Service Market Has Declined Substantially In the Past 13 Years Due to Increasing Competition In Their Core Markets, Including the Access Service Market

The FCC's 1983 conclusion that independent LECs might damage interstate service competition by unlawfully raising the costs of interstate service providers was based on the agency's assumption that independent LECs face little competition in the access service market. This fact, according to the Commission, gave these LECs a substantial incentive to seek to damage competition in the interstate service market.

Even assuming that independent LECs had market power in the access service market in 1983, that power has declined substantially since then. Competitive access providers have deployed access service networks of their own in scores of cities and towns in the last decade. These networks give both interstate service providers and end users an alternative source for both special access service and for the transport component of switched access service.

The fact that independent LECs have reduced carrier access charges in recent years is evidence that competition now exists in the access service market. For example, SNET has reduced the price it charges interstate carriers for interstate switched access service by nine percent in the last three years and 21.4 percent in the last six years.

Far-reaching regulations adopted by the FCC early this month to implement Sections 251 and 252 of the Communications Act are designed specifically to reduce even further whatever market power a LEC still has in any market.[18] By their terms, these new regulations apply immediately to independent LECs controlling 80 percent of all independent-LEC-owned access lines.[19] Moreover, the rules give state communications regulatory agencies full authority to apply the same requirements to a LEC controlling any of the remaining 20 percent of independent-LEC-owned access lines immediately after that LEC receives notice from another party that the other party desires to compete with that LEC.[20]

Not only are the FCC's new rules designed to eliminate any remaining LEC market power, they are structured to accomplish this objective quickly. They do so by establishing a negotiation/compulsory arbitration procedure which guarantees that anyone desiring to compete head-to-head with the LEC in its core markets will be

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[18] See Implementation of the Local Competition Provisions in the Telecom. Act of 1996, First Report and Order, CC Dkt. No. 96-98 (FCC 96-325, rel. Aug. 8, 1996); Id., Second Report and Order (FCC 96-353, rel. Aug. 8, 1996).

[19] Id., First Report and Order at ¶1253 (applying the new rules to all LECs except those which constitute a "rural telephone company" as defined in Section 251(f)(1) of the Act. Just 20 percent of the access lines of independent LECs meet this definition of lines owned by a "rural telephone company").

[20] Id. at ¶¶1253 and 1263 (holding that state communications regulatory commissions have broad authority to decide whether to impose the new rules on a "rural telephone company").

able to do so effectively within nine months of the date on which the competitor asks the LEC to begin negotiations.[21]

FCC Chairman Hundt has predicted that competition with LECs will begin in earnest by Christmas.[22] MCI Chairman and CEO Bert Roberts apparently concurs since he is quoted as saying that the FCC's new rules "will encourage the quick entry of competitors into monopoly . . . [LEC] markets. . . ."[23]

For many independent LECs, these predictions are demonstrably correct. For example, both AT&T and MCI informed SNET early this year that they want to compete head-to-head with SNET throughout SNET's service area and in all of SNET's core service markets, and SNET began negotiations with both companies in March. Under the nine month timeline set forth in the Commission's new rules, both companies should be in a position to participate actively in all of SNET's core markets before 1996 ends.

An independent LEC's lack of market power justifies permitting that LEC to offer in-region interstate service under non-dominant regulation through its access affiliate using either test. If the Commission uses the market power test to decide whether to let independent LECs provide in-region interstate service under non-dominant regulation through their access affiliates, absence of

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[21] Id. at ¶22.

[22] "Price Defaults' Offered; FCC Approves Interconn. Order, Shifts Focus to States", Commun. Daily at 1 (Aug. 2, 1996).

[23] Bus. Research Publications, TR Daily at 6 (Aug. 1, 1996).

power in the access service market obviously justifies permitting these LECs to operate in this manner. This is so since the absence of power in the access service market eliminates the incentive that independent LECs otherwise might theoretically have to monopolize the in-region interstate market by misallocating interstate service costs to access service or by providing inferior access service to their respective interstate service competitors.

By contrast, if the Commission uses the balancing test to decide whether to let independent LECs provide in-region interstate service under non-dominant regulation through their access affiliates, any reduction in market power from the 1983 level justifies permitting these LECs to operate in this manner even if the agency believes that the LECs' market power has not been eliminated. This is so since the benefit of increased operating efficiency that results from provision of interstate service under non-dominant regulation through the access service affiliate outweighs the reduced risk that the LEC could damage competition in the in-region interstate service market by misallocating costs or by providing lower quality access service to its interstate service competitors than to itself.

B. The Ability of Independent LECs to Damage Competition in the In-Region Interstate Market Also Has Declined Substantially Due to Massive Changes In the Structure of the Interstate Service Market and Increased FCC Regulatory Controls

Even if one were wrongly to ignore the fact that independent LECs have lost market power in the access service market in the past 13 years, the Commission still should permit independent LECs to provide in-region interstate service under non-dominant regulation through their access service affiliates. This is because their ability to damage competition in the in-region interstate service market has declined precipitously for two reasons. Each is discussed below.

1. The Interstate Service Market Is Far More Competitive Today than In 1983, and the Companies Who Dominate that Market Are Among the Largest Corporations In the World

The FCC's 1983 conclusion that an independent LEC might damage interstate service competition by unlawfully raising the costs of its interstate service competitors was based not only on the LEC's assumed market power in the access service market as indicated above, but also on the fact that competition in the interstate service market was then only beginning to develop. With an interstate service market filled with small, struggling competitors, the Commission felt that any leveraging of market power in the access market risked damaging competition.

It is debatable whether any leveraging, no matter how small, would have damaged interstate service competition in 1983. But it is true that competition was only beginning at that time and that the competitors were relatively small companies. This can be illustrated by noting that MCI, AT&T's largest competitor, then had less than four percent of the toll market and a tiny fraction of its present $15 billion in annual revenues.

Whatever may have been the validity of the Commission's 1983 assumption that any leveraging, no matter how small, could have damaged interstate service competition, that is plainly not so today given the interstate service market structure that now exists. Today, competition in the interstate service market is far more secure with MCI having increased its market share nearly five fold to 17.4 percent, Sprint having experienced a similarly large market share increase (2.7% v 10.1%), and AT&T having witnessed a 40 percent reduction in its market share (90.1% v. 55.2%).[24/] Competition is also more secure today in the interstate service market than ever before given the FCC's recent finding that the market is now characterized by high elasticity of supply.[25/] By definition, high elasticity of supply means new companies have an ability to enter a LEC's in-region interstate service market quickly and without substantial investment. The Commission summar-

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[24/] See Fed. Commun. Comm., Statistics of Commun. Common Carriers at Table 1.4 (1994/95 eds).

[25/] See Motion of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier, 11 FCC Rcd. 3271, 3303-07 (1995), recon. pending.

ized these developments less than nine months ago by holding for the first time that the interstate service market is now substantially competitive.[26/]

The more stable competitive environment that exists today in the interstate service market significantly reduces an independent LEC's ability to damage competition in the in-region interstate service market even if one were to assume wrongly that the LEC has market power in access service and thus an incentive to damage its interstate competitors. This new competitive environment reduces the LEC's ability to damage competition by giving the LEC's interstate service competitors a far better ability to withstand any effort to damage competition. This is the case because any of the four large interstate service providers that now provide far more than 90 percent of all interstate service (each of which is much larger than nearly all of the 1,110 independent LECs as explained above) can economically justify spending far more on advertising than the independent LEC, can spread the cost of providing interstate service over a much larger base of costs, and can afford to spend the money necessary to challenge -- at the FCC and in the courts -- any unlawful leveraging by the LEC.

The high elasticity of supply that characterizes the interstate service market today also reduces an independent LEC's ability to damage competition in the in-region market by unlawfully leveraging any power it has in the access service market. This is

[26/] Id.

the case since high elasticity of supply ensures that other companies have an opportunity quickly and economically to replace any interstate service competitor which leaves the business.[27]

The analysis in Attachment B demonstrates that the present structure of the interstate service market makes it irrational to impose dominant regulation on the in-region interstate service of an independent LEC's access service affiliate under either the monopoly power test or under the cost/benefit test. With regard to the monopoly power test, Attachment B shows that an independent LEC providing in-region interstate service through its access affiliate under non-dominant regulation has no ability to monopolize the in-region interstate service market. For example, it shows, by making a series of indisputably worst case assumptions, that interstate service providers who were the targets of even an unlawful access charge price increase of 25 percent by SNET (the third largest of the 1,100 independent LECs) would be required to raise retail interstate service prices because of SNET's unlawful conduct by a maximum of far less than two tenths of one percent. Even if SNET

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[27] See, e.g., Accounting Safeguards Under the Telecom. Act of 1996 at ¶16 (FCC 96-309, rel. July 18, 1996):

> "Even if . . . subsidization [of interstate service by misallocating access service costs] were to allow a . . . [LEC] . . . to sustain [interstate service] prices below costs for a period of time sufficient to drive out competing IXCs, the . . . [LEC] would be unlikely to raise prices above the competitive level, since each IXC's network represents an embedded facility which could be purchased in a bankruptcy proceeding and used if the . . . [LEC] affiliates subsequently attempted to raise interstate service prices above the competitive level."

could have monopolized the in-region interstate service market 13 years ago by unlawfully forcing interstate service competitors to raise their retail prices by less than two tenths of one percent, it obviously could not do so now given the existing structure of that market.

The analysis in Attachment B likewise shows that it is now irrational to regulate the in-region interstate service offering of an independent LEC's access affiliate under dominant regulation using the cost/benefit analysis rather than the monopoly power test. Little benefit would result from dominant regulation given that independent LECs would be unable to force their in-region interstate service competitors to raise prices by a noticeable amount in the absence of dominant regulation. By contrast, the cost of providing interstate service under dominant regulation through the access service affiliate is substantial as the FCC already has found. So is the cost of providing such service under non-dominant regulation through an entity other than the access service affiliate as the Commission also has found.

2. Numerous FCC Regulatory Policies Implemented In the Last Decade Have Substantially Reduced An Independent LEC's Ability to Leverage Market Power In the Access Service Market

While changes in the interstate service marketplace preclude an independent LEC from damaging the in-region interstate service market (even wrongly assuming the LEC has market power in access service sufficient to give it an incentive to do so), the Commission need not rely on those marketplace changes alone. An independent LEC's ability to damage competition in the in-region interstate service market also has been reduced by a variety of FCC regulations adopted in the past 10 years. Those regulations are discussed below.

First, the FCC significantly lessened a LEC's ability unlawfully to leverage access service market power into the interstate service market when it revamped its cost accounting rules in 1986.[28] These 1986 rules establish a uniform accounting system and a uniform set of cost allocation principles which all Class A LECs must use in allocating costs between access service and other services, including interstate service.[29] The 1986 rules also

[28] These rules were adopted in Joint Cost Order, 2 FCC Rcd. 1298 (1986), recon. 2 FCC Rec. 6283 (1987), further recon. 3 FCC Rcd. 6701 (1988), aff'd sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990). See also Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services at ¶39 (FCC 96-288, rel. July 1, 1996) (explaining that independent LECs providing interstate service must allocate costs between access service and interstate service in accordance with these rules).

[29] The cost allocation rules mandate that any access service provided by the LEC for its provision of interstate service must be recorded at the tariffed rate. See 47 U.S.C. §64.901(b)(1). They also require all costs of switching and transmission facilities owned by the LEC to be (a) directly assigned to interstate service if used exclusively for provision of interstate service or (b) allocated to access and interstate service in accordance with the principles of cost causation specified in the rules if used jointly to provide both access and interstate services. See 47 C.F.R. §64.901(b)(3) (direct assignment) and 47 C.F.R. §64.901(b)(3) (allocation of common costs). The overwhelming majority of independent LECs rarely if ever would need to allocate the cost of transmission and switching equipment between access service and interstate service since they provide interstate service as (continued...)

require these LECs to develop a cost accounting manual establishing procedures for allocating costs based on these allocation principles. These rules are designed specifically to prevent LECs from recovering, from access service, any costs of providing non-access service, including interstate service. Since they are applicable to all Class A LECs, they apply to independent LECs controlling more than 85 percent of independent-LEC-owned access lines. This is because a Class A LEC is any LEC with more than $100 million in annual common carrier service revenues.[30/] More than 85 percent of the access lines of independent LECs are owned by LECs having more than $100 million in annual common carrier revenues.

Unlike in 1983, moreover, independent auditors now must attest every year that each Class A LEC's accounting books conform with all applicable FCC regulations, including the agency's 1986 cost allocation rules.[31/] Commission auditors also review these independent audits.[32/] And the agency uses ARMIS, an automated data

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[29/] (...continued)
resellers and have no ability economically to deploy transmission or switching equipment to provide such service given the massive investment that is necessary to provide interstate service as a facilities-based carrier.

[30/] 47 C.F.R. §32.11.

[31/] See Computer III Remand Proceedings: Bell Operating Co. Safeguards and Tier I Local Exch. Co. Safeguards, Report and Order, 6 FCC Rcd. 7571, 7593, vacated in part and remanded, Calif. v. FCC, 39 F. 3d 919 (9th Cir. 1994). See also Joint Cost Order, supra, 2 FCC Rcd. at 1329-33.

[32/] See Computer III Remand Proceedings, supra, 6 FCC Rcd. at 7593.